SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Mountjoy | Analyst: Marion Mann DeJong | Bill Number: SB 2096

Related Bills: See Legislative History | Telephone: (916) 845-6979 | Introduced Date: 02/20/98

Attorney: Doug Bramhall | Sponsor: Ind. Bus. Coalition

SUBJECT: Free Agent Insurance Expense Deduction

SUMMARY

This bill would provide for a new form of insurance known as “free agent insurance.” Free agent insurance would include disability (health care benefits, and loss of wages arising from disability), unemployment, and life insurance and retirement annuities.

Under the Revenue and Taxation Code (R&TC), this bill would provide a deduction for expenditures for free agent insurance.

EFFECTIVE DATE

This bill would become effective on January 1, 1999. The deduction would apply to each taxable year beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 38 (Stats. 1993, Ch. 954).

PROGRAM HISTORY/BACKGROUND

Generally, employment occurs when an employer engages the services of an employee for pay. Employers are responsible for reporting wages paid to their employees and paying unemployment insurance (UI) and employment training tax (ETT) on those wages, as well as for withholding and remitting state disability insurance (SDI) contributions and personal income tax (PIT) due on wages paid to workers.

An employee includes (1) an officer of a corporation, (2) a worker who is an employee under the usual common law rules, and (3) a worker whose services result in employee classification by statute.

A common law employee is an individual who is hired by an employer to perform services and the employer has the right to exercise control over the manner and means by which the individual performs his or her services. The right of

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR’S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR’S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department Director Date G. Alan Hunter 3/30/98	Agency Secretary Date	By: Date

control, regardless of whether exercised, is the most important factor in determining whether an individual is an "employee." The right to discharge a worker at will and without cause is strong evidence of the right of direction and control.

A worker not considered a common law employee may be a statutory employee by law for purposes of UI, DI and ETT under circumstances that include, but are not limited to, agent or commission drivers, home workers, traveling or city salespersons, writers (as specified), and construction workers.

Independent contractors are not employees. They are engaged in separately established bona fide businesses. They are usually contracted to perform specific tasks, and they have the right to control the way the work is to be accomplished. Generally, an independent contractor is anyone who is not an employee under the common law rules unless they are statutory employees.

SPECIFIC FINDINGS

Under current federal and state laws, employers are allowed to deduct amounts paid or incurred for trade or business expenses, including compensation paid to employees which may include contributions to employee medical/health care insurance plans, amounts paid for employee life insurance policies, contributions to employee pensions plans, amounts paid for unemployment compensation, contributions by small employers to Medical Savings Accounts (MSAs) of eligible employees and amounts paid for workers compensation. Generally, these benefits are not included in the employee's income.

Under federal and state law, as a pilot program, a certain number of employees covered under a small-employer-sponsored high deductible health coverage plan may establish a medical savings account (MSA) and are allowed a tax deduction for cash contributions they make to their MSA. Any contributions that an employer makes to an employee's MSA are business expense deductions, and the amount contributed is not includable in the employee's income. Withdrawals from MSAs for qualified medical expenses, including long-term care and insurance contracts, are not taxable.

Under existing federal and state laws, individuals who itemize deductions may deduct medical expenses for themselves, a spouse and any dependents. However, the deduction of medical expenses, as defined under Section 213 of the Internal Revenue Code, is allowed only to the extent they exceed 7.5% of federal adjusted gross income (AGI). Medical insurance premiums are combined with other medical expenses, including prescribed drugs, and are deductible subject to the 7.5% AGI floor. Premiums paid by individuals for life insurance or income protection policies are not deductible.

Under current federal law, self-employed individuals can deduct 45% of the amount they pay or incur for health insurance for themselves, their spouse or dependents for 1998 through 2002. The percentage amount is increased to 50% for 2003, 60% for 2004, 70% for 2005 and 80% for 2006 and thereafter. The deduction is limited to the extent the self-employed individuals have net profit and cannot be taken if they are eligible to participate in their or their spouse's employer-provided health plan. If the self-employed person itemizes his/her deductions, the remaining premium costs can be included with all other medical expenses, subject to a 7.5% AGI floor.

Existing California law provides for a deduction in determining AGI of 25% of a self-employed individual's cost for health insurance. The deduction is only allowable as long as a federal health insurance deduction remains in effect.

Under federal and state law, a taxpayer can deduct up to $2,000 per year for contributions made to a deductible Individual Retirement Account (IRA). This amount applies to all individuals who were not active participants in an employer-sponsored retirement plan. However, an individual who is an active participant in an employer-sponsored retirement plan may deduct the full $2,000 if the individual's adjusted gross income (AGI) is below certain limits.

Under the Insurance Code, this bill would authorize the Insurance Commissioner to adopt regulations to establish "free agent insurance." Free agent insurance would include disability (hospital, medical and surgical benefits, health care benefits, and loss of wages arising from disability), unemployment, and life insurance and retirement annuities. Free agent insurance would be required to provide at least the same coverage as would be provided under the workers' compensation, unemployment compensation and unemployment disability compensation laws. Any insurer transacting workers' compensation insurance or disability insurance may offer free agent insurance and may provide coverage in addition to the coverage required by this bill.

A waiver of free agent insurance premiums would be provided during any period of permanent disability or for the first month's premium for a renewal after a six-month break in coverage. Free agent insurance would not be subject to cancellation and would be guaranteed renewable except for nonpayment of premium or fraud. Disputes would be resolved by arbitration within three months. Excess underwriting profits would be credited to policyholders with favorable claims experience, to be used for a retirement annuity.

Individuals desiring to act as a free agent would register with the Secretary of State (SOS) by providing proof of free agent insurance. The SOS would provide requesting employers confirmation that an individual is registered as a free agent.

Under the Labor Code, this bill would provide that any person who provides services for another pursuant to a free agent agreement would be a "free agent" and not an employee of the employer. To enter a free agent agreement, the individual must do both of the following:

- Have and maintain a free agent insurance policy.
- Enter into an agreement with the employer that (1) any injury suffered by the free agent while providing services shall be paid solely form the free agent insurance policy and (2) any dispute between the free agent and the employer shall be determined by the Department of Industrial Relations in accordance with procedures established by that department.

Under the R&TC, this bill would provide a deduction for expenditures for free agent insurance.

Under the Unemployment Insurance Code, this bill would exclude free agents from the definition of employee.

Policy Considerations

This bill would raise the following policy considerations.

- Although this bill would provide portable insurance coverage for individuals and prevent the loss of benefits when transitioning between jobs, without a similar federal plan there may not be sufficient incentive to become a free agent.

- This bill would provide 100% deduction for free agent insurance premiums. Currently, individuals that itemize can claim a deduction for medical expenses, including insurance premiums, to the extent that they exceed 7.5% of federal AGI. Self-employed individuals can deduct 25% of the amount paid or incurred for health insurance.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist with any necessary amendments.

- Without corresponding federal legislation, the California tax return for free agents would be more complex, especially if the free agent is treated as an employee for federal purposes and a self-employed individual for state purposes. For example, a taxpayer treated as a federal employee would include wages on the appropriate line on the Form 1040, Form 1040A or Form 1040EZ. For California purposes, the taxpayer would be required to file Form 540 with a Schedule C. Adjustments would be required for the differences in wages and Schedule C income.

  Further, taxpayers might be confused because their wages would be subject to federal withholding while they would be required to pay estimate payments for California purposes to avoid underpayment penalties.

- It is unclear whether expenditures made by free agents for free agent insurance would be trade or business expenses of a self-employed individual and thus deductible from gross income or an itemized deduction of an employee.

  If treated as if self-employed, the taxpayer would file a Schedule C, pay self-employment taxes and make estimate payments. The taxpayer would claim the deduction for free agent insurance on the Schedule C.

  If treated like an employee, the compensation would be subject to withholding and the taxpayer would report wages like an employee. The taxpayer would make an adjustment to federal income, on Schedule CA, for the deductible free agent insurance expenditures.

- The deduction is allowed for expenditures for “free agent insurance.” However, the Insurance Code provides for “free agent coverage,” which includes "levels of insurance" including disability, wage loss and life insurance and "related coverage" which includes annuity benefits for retirement. It is unclear whether the deduction is to be limited to "levels of insurance" or whether it includes all "free agent coverage." If the author intends that all expenditures qualify, then the term "free agent insurance" should be replaced with "free agent coverage."

Technical Considerations

Amendment 1 would replace an incorrect word.

Amendment 2 would replace the term "expenditures" with "the amount paid or incurred."

FISCAL IMPACT

Departmental Costs

If amended to resolve the implementation considerations, this bill would not significantly impact the department's costs.

Tax Revenue Estimate

As a rule of thumb, for every 100,000 free agents revenue losses over the initial four-year period are estimated to be as follows:

Rule of Thumb for every 100,000 Free Agents Fiscal Year Cash Flow Impact Effective for Tax Years Beginning On or After January 1, 1999 $ Millions			
1998-99	1999-00	2000-01	2001-02
(16)	(41)	(42)	(45)

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

State revenue effects would depend on the number of individuals who participate in the free agent benefit program, the cost of premiums for those participating, and the marginal tax rates of taxpayers claiming this deduction.

In the absence of companion federal legislation, it would be costly for employers to reclassify employees as free agents for state purposes. Therefore, this estimate assumes that only taxpayers who are not currently employees would become free agents. Because the number of taxpayers who would become free agents is unknown, this estimate uses a "rule-of-thumb" based upon 100,000 free agents.

The estimate assumes that the average taxpayer who chooses to become a free agent would have income of $50,000 and that benefit premiums would equal 15% of income or $7,500 (this matches the ratio of spending on benefits to income for employer-provided benefit plans including retirement (other than social security), unemployment insurance, life insurance, workers compensation and group health coverage – Employee Benefits Research Institute home page). The estimate assumes a 5% growth rate, which is the average annual growth rate in employer spending on all benefits. The estimate also assumes a 4.5% average marginal tax rate applied to deductions.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 2096
As Introduced February 20, 1998

AMENDMENT 1

On page 3, line 34 strikeout "or" and insert:

of

AMENDMENT 2

On page 5, modify line 32 as follows:

amount equal to ~~any expenditures~~ the amount paid or incurred for free agent